LIENS OF THE RECEIVERSHIP OF A BUSINESS CORPORATION.—PART II.

Turning now to the state courts, we shall find a great divergence of decision. Some are quite as emphatic as the Federal courts in refusing to permit the receiver to incur indebtedness at the expense of the lien holders; others consider it a matter of right.

The matter was definitely settled in New York, as early as 1887, by the case of *Raht* v. *Attrill*,[1] an authority much relied on by Caldwell, Cir. J., in *Hanna* v. *State Trust Co.*[2] The Rockaway Beach Hotel was undertaken by a corporation which exhausted its means in the first six months, leaving the hotel far from finished. Then a receiver was appointed, who undertook to complete the work and operate the hotel with money borrowed on certificates. At one time a mob of unpaid and starving workmen became riotous and threatened to burn the building, and the referee found that they would have done so had not more money been advanced at once to pay them. Finally, a purchase money mortgage was foreclosed, and the net result of an expenditure of $1,000,000 to improve the property was a fund of about $86,000 wherewith to pay claims exceeding $800,000. The court said "this case illustrates what I apprehend has been the common experience, where a court, departing from its appropriate judicial function, has undertaken to manage and carry on the business of a failing and insolvent corporation." The priority given the certificates, although neither the mortgage trustee nor the bondholders had been made parties to the proceedings, led to a contest over the fund. The court went as far as seemed possible towards allowing the debts of the receivership: "It has become the settled rule that expenses of realization and also certain expenses, which are called expenses of preservation, may be incurred under the order of the court on the

[1] 106 N. Y. 423 (1887).

[2] 70 Fed. 2 (1895), (C. C. of A.)

credit of the property; and it follows, from necessity, in order to the effectual administration of the trust assumed by the court, that these expenses should be paid out of the income, or, when necessary, out of the *corpus* of the property before distribution, or before the court passes over the property to those adjudged to be entitled. It is claimed that the money advanced in this case to protect the property from an incendiary burning created a debt for preservation, which may be preferred to the claim of the bondholders. We are of a contrary opinion." It was the duty of the state to suppress riot and protect property, rather than of a receiver to buy his peace. The conclusion is accordingly reached: "It would be unwise, we think, to extend the power of the court, in dealing with property in the hands of receivers, to the practical subversion or destruction of vested interests, as would be the case in this instance if the order of August 17th should be sustained. It is best for all that the integrity of contracts should be strictly guarded and maintained, and that a rigid rather than a liberal construction of the power of the court to subject property in the hands of receivers to charges, to the prejudice of creditors, should be adopted."

The case of *Farmers' Loan & Trust Co.* v. *Bankers & Merchants' Telegraph Company*[1] deserves notice, for the business continued by the receiver was that of an important telegraph company. Priority over the mortgage bonds was sought by a creditor for advances made to the company just before the receivership. This, it will be remembered, involves an extension of the general principle invoked, that can be sanctioned only if the business is to be continued by the receiver, to keep the corporation a going concern until its assets are sold. The court went so far as to say: "There is a sound equity which supports the doctrine that, when the nature of the property is such that the business to which it has been devoted cannot be discontinued without great probable loss, the court may authorize it to be continued by its officer and receiver, pending the closing up of the affairs of the insolvent corporation. Expenses incurred by a re-

[1] 148 N. Y. 315 (1896).

ceiver under such circumstances may be justly said to be expenses of preservation for the benefit of bondholders, or other persons entitled to share in the final distribution, which ought to be first paid." The court examined the circumstances attending these loans, and found there was no equity demanding priority; accordingly this was refused, for "the right of a creditor of an insolvent corporation in the hands of a receiver to have a preference over bondholders under a first mortgage is *strictissimi juris*."

There seems to have been no direct decision on the subject in Pennsylvania until this year,[1] but two cases, just decided, merit notice. In *Gillespie* v. *Blair Glass Company*,[2] receivers were given authority to operate the glass works "with materials now on hand" and with such other materials as the court might authorize them to buy. They went beyond the scope of this order without asking permission of the court, and the operation of the plant resulted in a deficit. To make this good, the receivers asserted a claim against the fund realized by the sale of the plant, but the laborers had a statutory lien on this fund. Under these circumstances the court awarded the fund to the laborers, saying *inter alia*: "It is not necessary to inquire under what circumstances these receivers would be protected from loss by the court, since the question is not raised by the facts. . . . A chancellor will seek to protect one acting in strict compliance with his orders from loss, but one who has acted upon his own judgment has no right to expect the court to divest a clear legal right existing in others to save him from the consequences of his own unauthorized acts. The receivers had a designated fund in this case to which to look. When that fund was exhausted they knew it. If, instead of suspending the unprofitable operations, they chose to continue them and incur a considerable indebtedness which they knew they could not pay, their improper conduct gives them no claim upon the chancellor or the creditors for reimbursement. They are in the same position as other improvident debtors. The proceeds of the realty were already

[1] See, however, Lewis *v.* Linden Steel Co., 183 Pa. 248 (1897).
[2] 189 Pa. 50 (1899).

appropriated by the law to the laborers, and were beyond the reach of the receivers."

This manifestly leaves the main question undecided, but it came up almost immediately afterwards in *Lane* v. *Washington Hotel Company*.[1] The receiver of a hotel company continued in possession of leased premises and operated the hotel under the order of the court. The landlord's application for leave to distrain for rent accruing during the receiver's possession was refused by the court, but an equivalent lien on the fund to be realized was given instead. The venture proved unprofitable, the personal property on the premises subject to distraint did not bring enough to pay the rent, and part even of this fund was claimed by the receiver to pay his commissions and counsel fee. The receiver had been appointed at the instance of the company or of its creditors. The Supreme Court disallowed these claims of the receiver, saying: "Whether there can be any sound judicial reason for continuing the business of an insolvent hotel corporation, is, to say the least, very doubtful. But, without regard to this point, there is no power in the courts in the interests of creditors and stockholders to take possession of property, operate it as a hotel and deprive the owner of any legal right." The lien given on the fund was approved, as the orderly method of procedure in view of the receiver's possession, and it was necessarily paramount to any of his claims. "He could have no other or more favorable exemption from her demand than his insolvent, the hotel company, had, nor could the court give him any. He was not receiver for her estate, but for her tenant; no insolvency of her tenant, nor action of the court in the interest of the tenant's creditors, could prejudice the landlord's right to her rent, and this right continued as long as the receiver occupied her property under the terms of the hotel company's lease. The receiver, except for this lease, would have been an intruder upon her property, even though acting by the assumed authority of the court." But the audit of the account was necessary for the adjudication of the con-

[1] 190 Pa. 230 (1899).

flicting claims and it was right, therefore, that the landlord should contribute to its costs.

The powers sometimes attributed to a court are illustrated in a curious way by a recent case in Georgia.[1] The owner of a gold mine, solvent so far as appears, sought to restrain an alleged licencee from mining. The defendant thereupon prayed for a receiver, and the court not only appointed one but directed him to work the mine. The Supreme Court, on appeal, held the appointment proper enough as regarded a quantity of ore already mined, but commented severely on the authority given the receiver: "The court seized this property, directed the receiver to go into the mining business—confessedly one of the most hazardous in which any man can engage. Suppose, as the result of his operation, he had demonstrated that there was little gold in the mine, except such as had already been taken out, and fallen far short of realizing a sufficient fund to defray the expenses of the business venture, what would have been the position of the plaintiff, who, in the first instance, appealed to the court for his protection? His mine would have been destroyed. He would have been liable to be taxed the costs of the receivership, with the probability of having the expense of this business experiment shared by an insolvent adversary. . . . Necessarily, these matters are largely within the discretion of the trial judge, but at last it becomes a question of law whether the court can lawfully embark property seized by it in an industrial enterprise, and the exercise of this power depends upon how far such conduct may be fairly necessary to the preservation of the existing status, taking into consideration the character of the property, the uses to which it may be applied, and how far, and to what extent, use may be necessary to its preservation. So far as we are enabled to do so by judicial utterance, we are disposed to discourage the practice, at the present day too prevalent in the chancery courts, of undertaking to employ the judicial machinery in the conduct of commercial and manufacturing enterprises, the control of which should be more properly committed to private hands."

[1] Bigbee *v.* Seymour, 28 S. E. 642 (1897).

The same conclusion was reached in *Hooper* v. *Central Trust Company*.[1] where it was sought to give priority over a vendor's lien to certificates issued for funds used to improve the property of an ice company. "It would be exceedingly dangerous," said the court, "to concede to a court of equity the power to displace, in favor of receiver's certificates, subsisting liens on the property of private corporations or of individuals." This decision was affirmed a year later in *Diamond Match Company* v. *Taylor*.[2]

Similarly, in *Vance* v. *Shiawassee Circuit Judge*,[3] the Supreme Court of Michigan modified the appointment of a receiver of a box manufacturing corporation, and set aside so much of the decree as directed him to continue the business pending the litigation.[4]

These are the chief authorities in the state courts deciding the question in favor of the lien-holders. Opposed to them are several in Illinois, Virginia, Alabama, Texas, and perhaps some other states. Thus in Illinois there was recently a case[5] analogous to *Lane* v. *Washington Hotel Co*.[6] A receiver was appointed for a hotel property, with instructions to operate it and continue the business. This resulted in loss, for which a credit was claimed out of the fund, in preference to a claim for the proceeds of furniture left in the receiver's possession. The owner, however, had assented to the use of his furniture, and the court held he was estopped. The facts, therefore, did not directly involve the power of the court to make the expenses of the receivership a charge superior to prior liens owned by persons not parties to the suit. But the court went on to discuss the question in general terms: "The object of appointing a receiver is to preserve the property for the benefit of all parties interested. Sometimes this object is best attained

[1] 81 Md. 559 (1895).

[2] 83 Md. 394 (1896).

[3] 60 N. W. (Mich.) 761 (1894).

[4] See, also, Bushworth *v.* Smith, 34 Pac. (Colo.) 482 (1893), and Manhattan Trust Co. *v.* Seattle Coal and Iron Co., 48 Pac. (Wash.) 333 (1897).

[5] Knickerbocker *v.* McKindley Coal Co., 172 Ill. 535 (1898).

[6] 190 Pa. 230 (1899).

by continuing a business. When this is done, the court has the right—although it should exercise such right with great caution—to make the expenses of such business chargeable upon the *corpus* of the property, if the income is not sufficient to pay the same. . . . It has been held that, although this authority of a receiver to incur indebtedness, in order to keep the business a 'going concern' until the rights of the parties are adjusted and a sale is effected, ordinarily arises only in cases of railroad companies; yet the same rules may be applied in other cases under like circumstances."

The Court of Appeals had reached the same conclusion in the similar case of *Filkins* v. *Adams*,[1] where it was said the receiver of a partnership ought not to be the sufferer if the court erred in not surrendering a hotel to the lessor.

The Supreme Court, too, had already decided[2] that a mine could be operated to preserve leasehold interests from forfeiture; but "whether they should be kept on foot was a problem of business economy as well as of law. The jurisdiction of the court in such a case must be largely discretionary." Continuing the business for such a purpose is by no means unreasonable, we submit, for even a considerable expense in approaching a vein of ore might well cost less in the end than the forfeiture of the lease. In fact, it is such a case as was suggested by Judge Paul in *Fidelity Ins., Tr. & S. D. Co.* v. *Roanoke Iron Co.*[3]

Another hotel case was very vigorously contested in Alabama.[4] A receiver was appointed at the suit of the lessor to "conduct and operate the hotel," but the court made no order entitling him to raise money for the purpose. This, it was held, empowered him to purchase on credit, and all his debts, incurred in good faith, were ordered paid. "To prevent irreparable damage and loss, sometimes it is necessary to make provision, in cases of a going business, that the business be continued. . . . The party contracting with the receiver looks

[1] 60 Ill. App. 410 (1895).

[2] Wilmington Star Mining Co. *v.* Allen, 95 Ill. 288 (1880).

[3] 68 Fed. 623 (1895); see page 281, *supra*.

[4] Thornton *v.* Highland Ave. & Belt R. R. Co., 94 Ala. 353 (1891); 105 Ala. 224 (1894).

to the *rem*, the fund or property *in gremio legis*, backed by a pledge of the court that it shall be liable for all costs and expenses legitimately incurred in pursuance of its order and decrees. . . . If there is an income from the property, the current expenses should be first paid out of this; but, this failing, there is no doubt that the *corpus* may be applied to such necessary expenses. . . . Under such conditions the court should never surrender its custody of the property, or discharge the receiver, until all obligations incurred by him in the proper discharge of his duties have been adjusted and provided for."[1] The opinion from which we quote was expressly approved when the case came a second time before the court,[2] and the law may be considered well settled in that state.[3] The authorities chiefly relied on, it should be observed, were railroad cases in the Federal courts. Yet this same court, twenty years before, had spoken very differently of the foreclosure of a railroad mortgage. "We are not aware," it was said, in a most elaborate opinion, "of any principle of law or element of wise policy which would justify such a court (of equity), after so getting possession, in laying aside its judicial character and engaging, however hopeful the scheme, in the completion of unfinished undertakings and in raising money for this purpose, as the parties themselves could not, namely, by setting up liens which shall displace other and older liens, without the consent of the persons to whom they belong."[4]

But it should not be overlooked that the court's intention in the hotel case[5] was to preserve the good-will of a going concern as an asset for the creditors. When a receiver was applied for, merely to stave off creditors and earn an income from mines and stores wherewith to pay the debts after an indefinite time, the court refused the appointment quite as positively as a Federal court might have done.[6]

[1] 94 Ala. 353 (1891).

[2] 105 Ala. 224 (1894).

[3] Cf. Beckwith *v.* Carroll, 56 Ala. 12 (1876).

[4] Meyers *v.* Johnston. 53 Ala. 237, 338 (1875).

[5] Thornton *v.* Highland Ave. & Belt R. R. Co., 94 Ala. 353 (1891); 105 Ala. 224 (1894), *supra*.

[6] Little Warrior Coal Co., 17 So. 118 (1895); Etowah Mining Co. *v.* Wills Valley M. & M. Co., 17 So. (Ala.) 522 (1895).

The decisions in Virginia and Texas might, perhaps, be explained as resting on special facts, yet the opinions assert broadly a right to charge the *corpus* of the estate. In *Karn* v. *Rorer Iron Co.*,[1] the corporation's mines and furnaces were connected by a railroad, built apparently for the company's own use, and a bridge in this road was washed out. The receiver was authorized to borrow money on certificates to rebuild this bridge and make other repairs to put the property in saleable condition; he was directed also to operate the furnace. These certificates were given a lien prior to the mortgage bonds, although it would seem the property might well have been sold and the repairs and the rebuilding of the bridge left to the purchaser to undertake. Common experience shows only too often that such extensive repairs do not always enhance the value of a property to the extent of their cost, so the course pursued was likely to result in increased loss to the bondholders.

In reliance, no doubt, upon this case, a receiver was appointed for a coal company and instructed to complete its coke ovens. He was then directed to operate the plant for a year, to ascertain if the venture were profitable. His working capital was provided by an issue of receiver's certificates, to which the court gave a paramount lien. Fortunately for the other lien creditors, they had no notice of the application for these certificates. The original liens were, therefore, reinstated by the Supreme Court,[2] after the operation had resulted in a loss and the sale of the property did not meet the debts. But the power to issue such certificates in a proper case was again asserted—a power to be "exercised with the utmost caution, prudence and reserve," and always with notice to the parties in interest.

In the Texas case, *Ellis* v. *Water Co.*,[3] the receiver was directed to keep the water works in operation as a going concern for the supply of a city. The receivership was at the suit of a general unsecured creditor, and the certificates, expenses

[1] 86 Va. 754 (1890).
[2] Osborne *v.* Big Stone Gap Colliery Co., 30 S. E. (Va.) 446 (1896).
[3] 86 Tex. 109; 23 S. W. 858 (1893).

of administration and costs of the proceedings were charged in part on the fund in preference to existing liens. This was justified as follows :

"While we have no doubt that the power to authorize a receiver appointed by a court of equity to create debts is liable to a great abuse, and are of the opinion that in every case it should be exercised, if at all, with extreme caution, we know of no rule or principle that would restrict the power to railway companies only. . . . The authority granted to receivers in railway cases to create debts and to make them a charge upon the *corpus* of the property of the company, is usually justified upon this ground (*i. e.*, the public duty imposed) ; and yet it seems that there may be grave doubt whether it affords a solid foundation for the doctrine. It is not clearly seen that the courts have the power to appropriate any part of the property subject to a mortgage in the interest of the public, or to impair the mortgagee's security and the obligation of their contract, in order to discharge a duty the mortgagor owes to the public. But when a court has taken the control of property from its owners and has placed it in the hands of its receiver, it is its duty so to direct its management as to preserve its value for the benefit of all parties at interest. This may be best accomplished by a continuation of the business, although such continued operation may involve the danger of some loss. . . . If the creditors of the receiver could only look to such (*i. e.*, current) revenue for the satisfaction of their claims, he would be unable to obtain credit, and the operation of the works would be impracticable. Accordingly the rule is, that the expense of administering and preserving the property is to be charged, first upon the net income, and if that be not sufficient, then upon the property itself or its proceeds upon sale. Now, while the circumstances which justify the appointment of a receiver, without authority to incur indebteness in order to keep the property and business 'a going concern' until the rights of all parties can be adjusted and a sale effected, had not ordinarily arisen except in cases of railroad companies, no reason is seen why the same rules should not apply in other cases under like circumstances

. . . If the public have an interest in the continued operation of a railroad, so have they in that of water works constructed for the purpose of supplying water to the inhabitants of a city. So, also, if the property of a water company be placed in the hands of a receiver, it may be best preserved by continuing the operation of its works so as to maintain it a going concern."

We shall call attention, however, to the fact that the court's authorities do not all sustain this proposition. Nearly all of them arose out of railroad receiverships, and the Pennsylvania case of *Neaffie's Appeal*[1] is mis-stated. It is true the receiver of a shipbuilding concern was in that case authorized to issue certificates to enable him to complete certain vessels, and that these certificates were paid out of the fund; but the preference thus given was only over unsecured general creditors and not over creditors with vested liens.

This is the strongest assertion the writer has found of the authority to charge the *corpus* of the property with debts incurred by the receiver in operating it. It is based on both grounds—the public need, existing in this particular case, and the general right of a court in administering the affairs of an insolvent private corporation. There was also a local statute covering the case. No attempt is made to meet the argument used in so many cases supporting the opposite view, that while it may be better for the unsecured creditors, or even for those with junior liens, to carry on the business, the creditors with superior liens have vested rights not to be disturbed without their consent. Such rights were thus disturbed in railroad receiverships, but only after a long struggle and many dissenting opinions was the rule finally established. Even in such a case, a creditor asking no favors need grant none[2]—a distinction the Texas court seems to have overlooked.

The conclusion to be drawn from the cases appears to be that, from the point of view of strict right, a court cannot authorize the continuance, by a receiver, of a private business at the expense of those holding vested liens. At times, however, there are considerations of public interest involved, and

[1] 22 W. N. C. 31 (1888).

[2] Kneeland *v.* American Loan & Tr. Co., 136 U. S. 89 (1890).

it may be that in some special instances these will prevail, as they have done in the case of railroads. Thus far they have been given effect only in a very few of the State courts. The Supreme Court of the United States has yet to pass upon the question, but the other Federal courts and the State courts whose decisions are most entitled to weight have pronounced emphatically against any interference with vested liens, by continuing the business of a private corporation after a receiver has been appointed.

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